



COLLECTIVE INVESTMENT SCHEMES, EXCHANGE TRADED FUNDS & HEDGE FUNDS

Johann Scholtz, Dawid de Villiers and Lerato Lamola

2015 / 2016

WEBBER WENTZEL
in alliance with > Linklaters

COLLECTIVE INVESTMENT SCHEMES, EXCHANGE TRADED FUNDS AND HEDGE FUNDS

Johann Scholtz, Dawid de Villiers and Lerato Lamola

Introduction

The South African market for pooled investment vehicles is generally well regulated. Various forms of regulated investment vehicles currently exist. These include collective investment schemes and most types of exchange traded funds. Hedge funds are at present unregulated. There has, however, been progress recently in regulating hedge funds as collective investment schemes.

Collective Investment Schemes

The promotion of local and foreign collective investment schemes in South Africa is regulated by the Collective Investment Schemes Control Act, No. 45 of 2002 (CISC Act), and by the Conditions in Respect of a Collective Investment Scheme Carried on Outside but Promoted in the Republic.

Section 65(3) of the CISC Act provides that a person who solicits investments in a foreign collective investment scheme which is not approved in terms of the CISC Act, is guilty of an offence with the penalty being a fine and/or a term of imprisonment for up to five years.

The term “solicit” is defined to mean any act to promote investment by members of the public in a collective investment scheme.

A “collective investment scheme” is defined as a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio. It has the following characteristics:

- two or more investors contribute money or other assets to, and hold a participatory interest in, a portfolio of the scheme through shares, units or any other form of participatory interest; and
- the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed.

An “open-ended investment company” is defined as a company with an authorised share capital, which is structured to provide for the issuing of different classes of shares to investors with each class of share representing a separate portfolio with a distinct investment policy. The definition is not restricted to companies incorporated in South Africa and includes foreign open-ended investment companies.

It is significant to note a reference to “members of the public” in the definitions of “collective investment scheme” and “solicit”. The effect of the inclusion of these words is that any collective investment schemes that are not offered to “members of the public” will not fall within the ambit of the CISC Act and will thus not require the prior approval of the South African Registrar of Banks (Registrar).

The term “members of the public” is defined in the CISC Act as including:

- members of any section of the public, whether selected as clients, members, shareholders, employees or ex-employees of the person issuing an invitation to acquire a participatory interest in a portfolio; and
- a financial institution regulated by any law, but excluding persons confined to a restricted circle of individuals with a common interest who receive the invitation in circumstances that can properly be regarded as a domestic or private business venture between those persons and the person issuing the invitation.

New conditions for advertising and marketing have been released under the Advertising, Marketing and Information Disclosure Requirements board notice. The conditions provide a legal framework within which managers may advertise and market their products to ensure that investors base their investment decisions on full accurate and comprehensive information. The conditions promote the use of plain and understandable language in material to be used with investors and potential investors. The conditions apply to both local and foreign schemes.

At present, local and foreign hedge funds may not be registered under the CISC Act because of their investment techniques and policies. Future regulation of hedge funds will see hedge funds being regulated under the CISC Act.

The Registrar has promulgated a new set of conditions relating to foreign collective investment schemes. The conditions make provision for the marketing of foreign schemes in South Africa.

Regulation 28 and collective investment schemes

Collective investment schemes are traditionally regarded as a popular investment for pension funds. Section 36(1)(bB) of the Pension Funds Act, No. 24 of 1956, empowers the Minister of Finance to make regulations limiting the amount and the extent to which a pension fund may invest in particular assets. Regulation 28 provides expressly for collective investment schemes as a category of assets in which a pension fund may invest. Regulation 28(8)(b) provides as follows:

“In applying the limits set out in this regulation, subject to such prescribed reporting and disclosure, a fund may exclude the following assets or categories of assets -

- participatory interests in a collective investment scheme, in respect of which a fund obtained a certificate issued by the scheme at the end of the financial year of the fund, confirming that the assets of the scheme relevant to the fund have complied with the limits as set out in this regulation, provided that:
 - the auditor of the scheme confirms the accuracy of the certificate at the financial year end of the scheme; and
 - the confirmation is available to the fund on request.”

Regulation 28(8)(b) effectively means that a pension fund does not have to take into account an investment in a collective investment scheme for Regulation 28 purposes, provided that the scheme is able to produce a certificate confirming that the assets of the scheme relevant to the fund comply with the limits set out in Regulation 28.

In other words, if the underlying assets of a portfolio of a collective investment scheme comply with the limits set out in Regulation 28 (ie if the collective investment scheme complies with the limits prescribed in Regulation 28), a pension fund is not subject to any investment limitations when it invests in such a scheme. The investment in the scheme itself is, in effect, not taken into account for Regulation 28 purposes.

Another way of looking at this would be to consider the scheme to “step into the shoes” of the pension fund, such that whatever limitations the pension fund would have been subject to will apply in respect of the scheme’s investments through its portfolios.

This means that it is imperative for collective investment schemes that wish to market themselves to pension funds to ensure that they invest, through their portfolios, in assets of the type provided for and subject to the limits set out in Regulation 28.

Exchange Traded Funds

Exchange Traded Funds (ETFs), also called tracker funds, are fully funded (unleveraged) securities listed on the Johannesburg Stock Exchange (JSE) that track the performance of a basket of shares, bonds or commodities.

There is no limit to the size of the fund and the liabilities of the fund are “participatory interests” in the fund. In South Africa, ETFs are subject to the listing requirements of the JSE, and are usually (but not always) structured as a collective investment scheme as determined by the CISC Act. There are currently around 44 ETFs listed on the JSE, the first of which was the SATRIX fund (which Webber Wentzel advised on).

Hedge Funds

Hedge fund managers

Amidst growing concern about the perceived lack of transparency in the South African hedge fund industry, which is estimated to be worth approximately ZAR 26 billion, the Financial Services Board (FSB) published regulations governing the conduct of hedge fund financial services providers (hedge fund FSPs).

The regulation of the hedge fund industry is particularly important due to the fact that investors in hedge funds stand to suffer spectacular losses. The regulations comprise three separate board notices issued in terms of the Financial

Advisory and Intermediary Services Act, No. 37 of 2002 (FAIS).

Currently, therefore, hedge funds in South Africa are not regulated but will be in future. The proposed regulations will regulate hedge funds at product or fund level. The conduct of their managers is already regulated under the FAIS. Broadly speaking, the regulations concern the:

- establishment of certain “Fit and Proper Requirements” for hedge fund FSPs;
- procedures which hedge fund FSPs are required to follow in order to obtain authorisation to act as such; and
- creation of a code of conduct for hedge fund FSPs.

Going forward, it is important to note that the envisaged CIS (hedge fund) manager, under the draft Regulations, who is registered under the CISC Act is distinct from the Category IIA Financial Services Provider registered under FAIS. The CIS (hedge fund) manager will be registered and regulated in terms of the CISC Act.

Fit and Proper Requirements

Currently the Fit and Proper Requirements, promulgated under the FAIS, make it obligatory for anyone managing a hedge fund to apply to the FSB for a Category IIA financial services provider licence.

In essence, a Category IIA FSP licence includes all persons who conduct the activities of a hedge fund FSP. In terms of the regulations, Category IIA FSPs are required to:

- have a track record of managing particular hedge fund strategies;
- adequately demonstrate knowledge, skill and competency in managing all instruments and asset classes comprising a hedge fund portfolio as optimised by, and in conjunction with, the requisite hedge fund strategies employed from time to time; and
- display certain character qualities such as honesty and integrity.

Application for authorisation requirements

The regulations provide for a number of standardised forms which an applicant for a licence to act as a hedge fund manager is required to complete and submit to the FSB. It would seem, from the questions on the application forms, that the FSB is concerned about risk management independent from the fund manager, as well as the valuations of unlisted instruments.

Code of Conduct for hedge fund FSPs

The Code of Conduct for hedge fund FSPs (Code) prescribes certain rules of practice in relation to hedge fund FSPs.

In the first instance, the Code provides that the relevant requirements for discretionary FSPs will apply to hedge fund FSPs and their clients, as if they were originally enacted for that purpose, but subject to necessary changes.

Significantly, hedge fund managers are now required, prior to rendering any intermediary services to a client, to provide the client with a written disclosure concerning the:

- applicability of the requirements for discretionary FSPs to the relationship between the client and the relevant hedge fund FSP; and
- risks involved in the hedge fund, in a format from time to time determined by the Registrar.

A hedge fund manager is also required to obtain a written confirmation from a client that the client received the prescribed written risk warnings and other specific disclosures the hedge fund FSP was required to make in terms of the regulations.

The content of the risk warning is prescribed by the FSB. It includes details about the specific risks of investing in hedge funds (eg that the valuation of unlisted securities is more difficult than the valuation of listed securities); and where leverage is employed, that the fund's volatility may be amplified.

A hedge fund manager will also be required to obtain a signed mandate from the client, prior to rendering any intermediary services to a client. The signed mandate must confirm the existence and contents of the mandate.

If the mandate involves the use of a hedge fund portfolio to execute the intermediary services required by the client, additional requirements will attach to the mandate. In such instances, the mandate must contain express confirmation by the client that he or she approves of the:

- investment objectives, guidelines and trading philosophy of the hedge fund FSP as disclosed and stated in the mandate; and
- process to be implemented in the form of strategies or positions (including leverage and/or net short positions, borrowing limits, and risk management principles to mitigate interest rate, liquidity and credit and derivative risk); risk profile; and risk management (for instance, a sensitivity analysis) as disclosed and stated in the mandate.

This mandate should also contain an express confirmation by the client that:

- he or she takes note of the FSP's affirmation, as stated in the mandate;
- the establishment of the relevant portfolio does not conflict with any law; and
- the operation and management thereof will continuously comply with any law that may be applicable thereto.

Hedge funds themselves

In 2013 the National Treasury (Treasury) and the FSB released, for public comment, a proposed framework for the regulation of hedge funds in South Africa. The framework proposed that the regulatory framework for hedge funds be housed within the existing CISC Act as a declared scheme by the Minister of Finance in accordance with Section 63 of the CISC Act and subsequently through the creation of a separate chapter for hedge funds within the CISC Act.

This framework proposes two types of hedge funds, namely Restricted and Retail Hedge Funds:

- Restricted Hedge Funds (Qualified Investor Hedge Funds): will not be allowed to market themselves to or solicit funds from the general public. They will, instead, be limited to private arrangements among qualified investors, and they will not be subject to all the strict regulations under the CISC Act. They will have to disclose, among other things, the number of clients and details of their counterparties, and will have to lodge annual returns so the Registrar can assess their levels of leverage.
- Retail Investor Hedge Funds: will be able to market themselves to, and solicit funds from, the general public. Ordinary retail investors will be able to invest in them. They will be subject to appropriate CISC Act regulations to ensure adequate investor protection. There will be rules governing the types of assets these funds can invest in and limits on the level of leverage permitted.

Draft Regulations have recently been released giving effect to the proposed framework. A hedge fund is defined in the draft Regulations as a collective investment scheme which uses any strategy or takes any position which could result in the portfolio incurring losses greater than its aggregate market value at any point in time, and which strategies include but are not limited to leverage and net short positions.

The draft Regulations allow for both types of hedge funds to use or invest in derivative instruments.

It is envisaged that a 12-month transitional period will be established from the time the draft Regulations are promulgated to give stakeholders time to apply and register for the necessary licenses and authorisations. It is envisaged the draft Regulations will be enacted before the end of 2014.

Conclusion

The South African and foreign market for pooled investment vehicles is watching developments in the collective investment scheme and the hedge fund space closely. It is also anticipated that the proposed new framework for hedge fund regulation will result in greater regulatory certainty and consistent treatment.